

IT99-4

Tax Type: Income Tax

Issue: Business/Non-Business (General)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

THE DEPARTMENT OF REVENUE)	Docket No.	98-IT-
OF THE STATE OF ILLINOIS,)	Tax ID No.	
v.)	Tax Years Ending	6/94-6/95
ABC, INC.,)	John E. White,	
Taxpayer.)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: JOHN DOE appeared for ABC, Inc.; Ralph Bassett appeared for the Illinois Department of Revenue.

Synopsis:

The Illinois Department of Revenue ("Department") issued a Notice of Deficiency ("NOD") to ABC, Inc. ("ABC" or "taxpayer"), which proposed to assess additional Illinois income and replacement tax for tax years 1994 and 1995. ABC protested that NOD, and requested a hearing. The sole issue is whether taxpayer correctly reported certain capital gains, dividends and interest as nonbusiness income on its Illinois tax returns for the applicable years.

A hearing was held at the Department's offices in Chicago. Taxpayer's chief financial officer and its accountant testified at that hearing. Certain of ABC's books and records were also introduced into evidence. I am including in this recommendation findings of fact and conclusions of law. I recommend that the issue be resolved in favor of taxpayer.

Findings of Fact:

1. ABC is a corporation that is engaged in the business of designing, manufacturing and selling exhibition displays throughout various states, including Illinois. Department Exhibit ("Ex.") 3 (Auditor's Comments), p. 1; Department Ex. 4 (ABC's Protest), p. 2; Department Exs. 5-6 (ABC's federal forms 1120 for tax years ending 6/94 and 6/95, respectively), p. 3 (of each return).
2. ABC's fiscal year runs from July 1 through June 30. *See, e.g.*, Department Exs. 7-8 (ABC's Illinois forms IL-1120 for tax years ending 6/94 and 6/95, respectively), p. 1 (of each return).
3. On or about June 30, 1989, ABC used some of its working capital to purchase a portfolio of marketable securities issued by unrelated companies. *See* Department Exs. 5-6 (p. 5, Schedule D, Part II, line 6 of each federal form 1120).
4. The securities ABC purchased on 6/30/89 included: 17,600 shares of ABC BANK; 2175 shares of XYZ Gas & Electric; 9000 shares of SODA POP; 4000 shares of XXX Corp.; 2000 shares of ZZZ Oil; and 4919 shares of BBB CORP.. Department Exs. 5-6 (p. 5, Schedule D of each exhibit).
5. ABC held the securities for a period of years, and then sold them. Department Ex. Department Exs. 5-6, p. 5 of each exhibit.
6. ABC's sale of that portfolio yielded a capital gain of approximately \$514,000 for its fiscal year ending June 1994, and a gain of approximately \$580,000 for its fiscal year ending June 1995. Department Ex. 1, p. 4; Department Ex. 2, pp. 1, 5; Department Exs. 5-6, p. 5 of each exhibit.
7. During the years at issue, ABC's gross sales were approximately 10.5 million

- dollars and 11.6 million dollars, respectively. Department Exs. 5-6, p. 1 (line 1) of each exhibit.
8. ABC used the gain from its sale of the securities to help finance its purchase and construction of a new office and manufacturing facility in Ohio. Department Ex. 3, pp. 2-3; Department Ex. 4, p. 2.
 9. On its Illinois returns for the tax years at issue, ABC reported the capital gains as nonbusiness income allocable to Ohio. *See* Taxpayer Exs. 7-8, p. 3 (Schedule NB of each Illinois form IL-1120).
 10. During prior tax years, ABC reported the dividends and interest earned from its portfolio of securities as nonbusiness income allocable to Ohio. Tr. pp. 21-22 (JIM DOE); *see also* Department Ex. 3, p. 1.
 11. Following an audit of ABC's returns for fiscal years ending 6/94 and 6/95, the Department determined that the capital gains, interest and dividend income was business income, and subject to apportionment by Illinois. Department Exs. 1-3.
 12. The Department reclassified the capital gains, dividends and interest as business income because those items of income were "earned from investments made with excess working capital from the business operations." Department Ex. 3, p. 2.
 13. The Department issued an NOD assessing tax in amount of \$1,748 for ABC's fiscal year ending 6/30/94, and tax in the amount of \$749 for its fiscal year ending 6/30/95. Department Ex. 1 (NOD), pp. 2-3.

Conclusions of Law:

This matter involves whether certain items of income should have been reported as business income on ABC's returns, or whether ABC properly reported those items as

nonbusiness income. Under the provisions of the Illinois Income Tax Act, ("IITA"), business income is apportioned among the states in which a taxpayer conducts business. 35 ILCS 5/304(a); Borden, Inc. v. Department of Revenue, 295 Ill. App. 3d 1001, 1009 (1st Dist. 1998). Nonbusiness income is allocated in whole to a particular state, depending on different statutory factors. 35 ILCS 5/303; Borden, 295 Ill. App. 3d at 1009. Section 1501(a)(1) of the IITA defines business income, in pertinent part, as follows:

The term 'business income' means income arising from transactions and activities in the regular course of the taxpayer's trade or business . . . and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations

35 ILCS 5/1501(a)(1). Nonbusiness income is defined as "all income other than business income or compensation." 35 ILCS 5/1501(a)(13).

Pursuant to § 904 of the IITA, the Department established the *prima facie* correctness of its determination that the items of income were business income when it introduced the NOD into evidence at hearing. 35 ILCS 5/904. A taxpayer claiming that an item of income is nonbusiness income bears the burden of clearly proving that fact. Texaco-Cities Service Pipeline Company v. McGaw, 182 Ill. 2d 262, 268 (1998).

The IITA's definition of business income establishes two separate and distinct tests by which income can be classified as business income: the transactional test and the functional test. Texaco-Cities, 182 Ill. 2d at 269; Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 711-12 (1st Dist. 1995); National Realty & Investment Co. v. Department of Revenue, 144 Ill. App. 3d 541, 554 (2d Dist. 1986). If either test is met,

the income is properly classified as business income. Texaco-Cities, 182 Ill. 2d at 269.

The transactional test is derived from the first clause of § 1501(a)(1) (transactions and activity in the regular course of the taxpayer's trade or business). Under the transactional test, income is business income if derived from a type of business transaction in which the taxpayer regularly engages. Texaco-Cities, 182 Ill.2d at 269 (*quoting* National Realty, 144 Ill.App.3d at 554); Dover, 271 Ill. App. 3d at 711-12. The functional test is derived from the second clause of § 1501(a)(1) (income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations). Under the functional test, the relevant inquiry is whether the property was used in the taxpayer's regular trade or business operations. Texaco-Cities, 182 Ill.2d at 269.

After the Department introduced its *prima facie* case, ABC offered the testimony of its CFO and of its accountant. JIM DOE, ABC's accountant, prepared ABC's federal and state income tax returns during the years at issue, and prior to those years. Department Exs. 5-8; Tr. pp. 21-22. On ABC's Illinois income tax returns, JIM DOE reported the items of income at issue as nonbusiness income allocable to Ohio. Department Exs. 7-8. JIM DOE testified that he reported the income as nonbusiness income because the stock portfolio ABC acquired in 1989 was unrelated to ABC's regular business operations. Tr. pp. 12, 20. JOHN DOE, ABC's chief financial officer, testified that ABC's purchase and holding of stock was a passive investment that had nothing to do with ABC's regular business operations in Illinois. Tr. p. 42. JIM DOE' and DOE's testimony is corroborated by the documentary evidence admitted at hearing, which showed that the securities ABC purchased were not issued by companies with any

apparent relationship with ABC, and that the number of shares ABC owned at any time was not sufficient to control any of the companies issuing them. Department Exs. 5-6; *see also* Department Ex. 4 (Protest).

Here, after considering all of the facts revealed by the record, I conclude that ABC has rebutted the Department's *prima facie* determination that the items of income should have been reported as business income, because the income fits into neither of the IITA's definition of business income. For example, ABC's federal tax returns show that all but approximately \$77,000 of the gain sought to be apportioned was realized from securities ABC purchased on 6/30/89. Department Exs. 5-6. In other words, its acquisition of the securities sold during 1993 and 1994 appeared to be an isolated event. Since the documentary evidence shows that ABC did not purchase, manage and dispose of securities as a part of its regular business operations, the gains do not constitute business income under the transactional test.

As to the functional test, the evidence shows that none of the securities ABC purchased were issued by companies with any apparent relationship to ABC. Department Exs. 5-6. JIM DOE and DOE testified that the issuers were not related to ABC. *See* Tr. pp. 19, 22-24 (JIM DOE), 42 (DOE). Additionally, the amount of common stock ABC purchased from any issuer was not sufficient for ABC to control the issuer's business. Department Exs. 5-6; Tr. p. 24 (JIM DOE); *see also* Department Ex. 4 (letter dated 1/30/98 from DOE attached to ABC's protest). Nor was the intangible property from which the income arose the kind of property ABC used in its regular trade or business operations. *See* Department Exs. 5-6. Finally, there is no evidence in the record that shows how ABC's acquisition, management and disposition of the securities might have

been integrally related to its regular business operations. Indeed, there is no evidence of any kind of *management* of the securities at all, but for ABC's mere holding of those securities for a period of four to five years. *See* Department Exs. 5-6, p 5 (of each return). At first blush, then, the income does not appear to constitute business income under the functional test.

During ABC's case-in chief, both DOE and JIM DOE quoted an example given in the Department's income tax regulation titled, "Business and nonbusiness income", 86 Ill. Admin. Code § 100.3010, and argued that the factual situation described in subparagraph (d)(5)(F) of that rule most closely matched the income the Department has attempted to characterize as business income here. Tr. pp. 19 (JIM DOE), 42 (DOE). That regulation provides, in pertinent part:

- (d) Items referred to in IITA Section 303 and unspecified items under IITA Section 301(c)(2).
 - (1) In general. ... Any item may, in a given case, constitute either business income or nonbusiness income depending on all the facts and circumstances. The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

* * * *
 - (5) Dividends. Dividends are business income where the stock with respect to which the dividends are received, is held or was acquired in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the stock is related or attendant to such trade or business operations.
 - (A) Example A: A corporation operates a multistate chain of stock brokerage houses. During the year the corporation receives dividends on stock it owns. The dividends are business income.
 - (B) Example B: A corporation is engaged in a multistate manufacturing and wholesaling business. In connection with that business the corporation

maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

- (C) Example C: Several unrelated corporations own all of the stock of another corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners of its stock. The corporations acquired the stock in order to obtain a source of supply of materials used in their manufacturing businesses. The dividends are business income.
- (D) Example D: A corporation is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the corporation holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.
- (E) Example E: A corporation receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the corporation. The dividends are business income.
- (F) Example F: A corporation is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the corporation's trade or business operations. The dividends and interest income received are nonbusiness income.

86 Ill. Admin. Code § 100.3010(d).

In each of the examples listed in subparagraphs (d)(5)(A) through (E) of the Department's business / nonbusiness regulation, the activities that gave rise to the

creation of dividend income, that is, the acquisition, management and disposition of the property that was sold, were, themselves, integral parts of the taxpayer's business operations. 86 Ill. Admin. Code § 100.3010(d)(4)(A)-(E). In example A, the dividend income is described as business income because the holder is engaged in the stock brokerage business, a business where acquiring and managing stock are regular, necessary, and therefore, integral activities of a brokerage house. In example B, the dividends are business income because the holder acquires, manages and disposes of stock as a regular, short term profitable use of funds required to be available for the operations attendant to the holder's business. *See Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 784, 112 S.Ct. 2251, 2261, 119 L.Ed. 2d 533 (1992) (all parties in *Allied Signal* conceded, and the United States Supreme Court agreed, that "short-term investment of working capital ... is apportionable"). In example C, the dividends constitute business income because each taxpayer/holder owns stock in a separate corporation in order to secure raw materials to be used in their separate business operations. In example D, the income is business income because the company owns stock as part of the reserves it is required to maintain for bonding purposes. Finally, in example E, the dividends are business income because the holder owns stock in another company that acts as the marketing agent for the holder's goods and/or services. In short, the applicable regulation's examples illustrate some of the different ways the acts of acquiring, managing and disposing of stock might constitute an essential part of the holder's "whole process of operating its business" (*see Texaco-Cities*, 182 Ill. 2d at 271; 86 Ill. Admin. Code § 100.3010(d)(5)(A)-(E)), as well as how the acts of acquiring, managing and disposing of stock might constitute a mere passive investment in stock. 86

Ill. Admin. Code § 100.3010(d)(5)(F).

When concluding its case, ABC's chief financial officer testified and argued that:

... Mr. Basset stated that this [the acquisition, management and disposition of stock] was an integral part of business operations. ... I can understand situations where a portfolio is used to support operations, circumstances where a portfolio might be tied to a self-insurance fund so it really relates to the insurance expenses of the company. I would expect that's probably the type of thing that can reasonably be identified as an integral part, because it's directly supporting the operations.

This portfolio is not. It was just set aside and totally excluded. It was not necessary to support the business in any way.

Tr. p. 42 (DOE). While DOE's testimony in the second quoted paragraph constitutes a conclusion, that conclusion is corroborated by the books and records admitted at hearing, which list the issuers, amounts, and purchase and disposition dates of the securities at issue. Department Exs. 5-6. Additionally, DOE's and JIM DOE' testimonies were clear and credible, and neither witness's testimony was improbable or unworthy of belief. *See Fillichio v. Department of Revenue*, 15 Ill. 2d 327, 333 (1958).

In response to ABC's argument that example (5)(F) was applicable here, the Department argued that that rule has no applicability because it presupposed the fundamental fact sought to resolved at hearing, that is, "what was the purpose of this investment." Tr. p. 37. The Department asserted, moreover, that the required "integral" connection to ABC's business was satisfied because the securities were purchased with excess working capital in 1989, because the portfolio was acquired with the intention of using whatever gain was realized to invest back into its business operations, and because the gains, in fact, were used to fund ABC's construction of a new office and manufacturing facility. Tr. pp. 33-34 (closing argument). The Department argues that

since the securities here were “acquired from working capital and ... held for the use of the business when they wanted to engage in significant capital improvements”, the gain should be considered business income. Tr. pp. 36-37.

Two points should be made regarding the Department’s response. First, one must assume that all corporate activities will be funded with the corporation’s available capital. Second, all expenditures of a company’s capital “in some sense can be said to be ‘for purposes related to or contributing to the [corporation’s] business.’” Asarco, Inc. v. Idaho State Tax Comm., 458 U.S. 329, 326, 102 S.Ct. 3103, 3114 (1982). If the question whether an intangible asset is “related” to the business of the company that purchases it can be answered in the affirmative simply by noting that the asset was acquired by the company’s working capital, and that the gain from the sale of that asset is used in the company’s business, then surely there will never be any dividend or capital gain income that will be found to be “unrelated” to the company’s business.

In that regard, the Department’s applicable regulation is truer to the IITA’s statutory distinction between business and nonbusiness income than the Department’s argument at hearing. The United States Supreme Court has consistently held that to satisfy due process concerns, the gain from a nondomiciliary corporation’s sale of stock is apportionable where the holder’s acquisition of the stock serves a function that is related to the company’s business operations within the taxing state, but not where the acquisition constitutes a mere passive investment. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166, 103 S.Ct. 2933, 2940, 77 L.Ed. 2d 545 (1983) (and cases cited therein). Examples (d)(5)(A) through (E) of the Department’s regulation on business and nonbusiness income illustrate some of the ways the acquisition, management and disposition of securities might serve an operational function. Example (F), in contrast, illustrates a situation in which the acquisition, management and disposition of securities serves as a passive investment.

Even though there is no question that ABC used the gains in its business operations, moreover, the gain here does not constitute business income because the functional test focuses on the taxpayer’s activities vis-a-vis the property or asset that

produced the gain, rather than on the taxpayer's use of the income once the asset is sold. Texaco-Cities, 182 Ill. 2d at 269-70 (“the second clause of section 1501(a)(1) focuses upon the role or function *of the property* as being integral to regular business operations.”) (emphasis added). Admittedly, the court in Texaco-Cities discussed taxpayer's use of the gain, but only to rebut taxpayer's citation to a case where a taxpayer sold assets used in its pipeline business as a business-ending transaction, and then turned the proceeds over to its shareholders. *Id.*, 182 Ill. 2d at 273-74. The majority in Texaco-Cities rejected the claimed similarity between the case at bar and the one cited by taxpayer, and noted that Texaco Cities used the gain from its sale of tangible property to fund its regular business operations. *Id.* There can be no doubt, however, that the basis for the Illinois supreme court's holding in Texaco-Cities was that taxpayer had previously used the property sold as an integral part of its transportation business — it was not based on the fact that taxpayer used the gain in its business operations. Texaco-Cities, 182 Ill. 2d at 273.

Department rule 3010(d)(1)'s provision that “[a]ny item may, in a given case, constitute either business income or nonbusiness income depending on all the facts and circumstances” (86 Ill. Admin. Code § 3010(d)(5)(1)), and the same rule's illustrations showing that a corporation's acquisition, management and disposition of stock might serve an operational function or might serve as a purely passive investment ((86 Ill. Admin. Code § 3010(d)(5)(4)(A)-(F)) was affirmed in Borden, Inc. v. Department of Revenue, 295 Ill.App.3d 1001 (1st Dist. 1998). In that case, the Department audited Borden's business and reclassified capital gains Borden earned from selling its wholly-owned subsidiaries as business income that was apportionable by Illinois. Following an administrative hearing, “[t]he ALJ concluded, and the Director agreed, ... that the acquisition, management and disposition of the Pepsi Subs stock constituted integral parts of Borden's regular trade or business. The circuit court affirmed.” Borden, 295 Ill. App. 3d at 1010.

When reviewing the correctness of that determination, the appellate court wrote:

Although no Illinois case is directly on point, the Department's regulations shed some light on the difference between business versus non-business income. For example, with respect to gains or losses from sales of assets, where a corporation constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the corporation, the gain is business income. 86 Ill. Adm. Code § 100.3010 (d)(3)(B)(1996). With respect to dividends, where a corporation is engaged in a multistate manufacturing business and also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the corporation's trade or business operations, the dividends and interest income received are nonbusiness income. 86 Ill. Adm. Code § 100.3010 (d)(5)(F) (1996).

The Pepsi Subs stock was not held as part of a portfolio of stocks which was unrelated to Borden's multistate business. Further, in light of Borden's restructuring and massive capital investment program, it cannot be said that income from the sale of the stock is so removed from Borden's trade or business as to be "clearly classifiable as non-business income." Kroger, 284 Ill. App. 3d at 479, 220 Ill. Dec. 566, 673 N.E.2d 710.

* * * *

We need not resort to the expansive test rejected by the Supreme Court in ASARCO in order to find that the sale of the Pepsi Subs stock was business income. The stock was not held as a passive investment, nor as one stock in a portfolio of stocks unrelated to Borden's unitary business. The Pepsi Subs were in the same general line of business as Borden, were part of Borden's unitary business, and their ultimate disposition was directly related to Borden's restructuring, a program that would take several years to complete. Based upon the foregoing, the Department's decision to categorize the capital gains as business income is not arbitrary or unreasonable and is supported by sufficient evidence. Obasi, 266 Ill.App.3d at 699, 203 Ill.Dec. 499, 639 N.E.2d 1318.

Borden, 295 Ill. App. 3d at 1011-12.

The documentary evidence admitted at the hearing in this matter includes

objective evidence to show that on 6/30/89, ABC purchased equity securities issued by different unrelated companies as a long-term investment. Department Exs. 5-6; Tr. p. 12 (JIM DOE). Thereafter, ABC held those securities for a period of years, until it sold them, and used the gains to finance the construction of a new office and manufacturing facility. *See* Department Ex. 4; Tr. pp. 18-19 (JIM DOE). The record, however, contains no evidence to show how ABC's acquisition and holding of others' stock materially contributed to, or was an integral part of, its regular business operations. For example, there was no evidence offered to show that, during the period of ABC's ownership of the stock, it pledged the stock as collateral for a loan or to secure a line of credit to finance its operations, or that the stock was held so ABC could maximize the amount of available working capital, or so that ABC could use the dividends and interest realized from its ownership to fund or otherwise support other aspects of ABC's business operations. Nor were any of the factual situations illustrated in rule 3010(d)(5)(A) through (E) shown to exist in this case. Instead, ABC's purchase of the securities portfolio was, for the most part, a singular occurrence. Department Exs. 5-6. Consequently, its holding and disposition of that portfolio did not constitute an integral part of ABC's regular business operations. In sum, the evidence shows that the income at issue was attributable to a passive investment in property that was unrelated, operationally, to ABC's business.

Since the income does not meet either of the IITA's definitions of business income, I conclude that ABC properly classified the gains, dividends and interest as nonbusiness income on its Illinois returns. After ABC rebutted the Departments *prima facie* case, the Department did not introduce any evidence to show that income at issue should be considered business income.

Conclusion:

I recommend the Director revise the NOD to show no liability, and that it finalize

that NOD as so revised.

11/23/99
Date

Administrative Law Judge